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Exporting America's Travails

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Given America's preeminent role in global growth, it has long been true that when the U.S. sneezes, the rest of the world catches a cold. Last year, a new theory came along: With the rise of China and India, along with progress toward structural reform in Europe and sounder economic policy in many emerging-market nations, maybe the U.S. has become "decoupled" from the rest of the world. That is, if the U.S. sneezes, does the rest of the world even notice? The global stock sell-off on Jan. 21 and scattered signs that some economies overseas are already under the weather brings a new urgency to the debate.

The issue is important because foreign trade is an increasingly crucial player in the U.S. outlook. Amid strong growth abroad, U.S. exports have risen 9.3% annually over the past two years. A narrowing U.S. trade deficit has added, on average, 0.5 percentage point per quarter to economic growth over that period, and trade is being counted on heavily to provide support through this year's economic weakness.

Clearly the linkage between U.S. activity and that overseas may not be as strong as it used to be, but it's not broken. U.S. influence is felt not only through the flow of goods and services. As recent events show, global financial markets are strongly linked. U.S. subprime turmoil quickly spread to Europe's credit markets, tightening conditions there. Global bourses have followed U.S. markets down, with effects on global wealth and spending. And the dollar's plunge has lifted many foreign currencies to trade-punishing levels. The Federal Reserve's three-quarter-point cut in its target rate on Jan. 22, surprising for both its size and timing, was a direct result of global market turmoil.

Two-Track Slowdown

So far, growth in the rest of the world is holding up, but some early signs of U.S.-led slowing are materializing. The euro zone's trade surplus slipped for the third month in a row. British holiday sales looked as sluggish as those in the U.S., and Germany's main gauge of investor expectations is at a 15-year low. Japanese growth is soft, with exports to the U.S. down for three consecutive months. Closer to home, Mexico's industrial output has slowed, and Canada is cutting rates amid a weakening outlook for exports.

Global growth will most likely follow two different tracks this year as industrialized nations gear down more than developing countries (chart). Europe, Canada, and Japan are more vulnerable to U.S.-related problems such as credit tightening and currency levels that hurt trade. However nearly half of U.S. exports go to developing nations. Growth there is more insulated from these issues and will continue at a slower but still brisk pace.

Growth in China, at more than 11% in 2007, will remain booming but slip a notch as U.S. growth slows and as policymakers try to cool off China's overheating economy. The rest of Asia will follow China but still benefit from its strength. Russia and OPEC will enjoy their oil revenues, and Latin America is well positioned for healthy growth. Solid gains in emerging-market nations, which are rapidly building their infrastructures, are a big plus for U.S. exports, almost half of which are capital goods and industrial materials.

Whatever downdraft America exerts on global growth this year, its impact will surely reflect the degree of U.S. weakness. Therein lies the risk. The U.S. is the world's largest exporter, but it is also the biggest importer. A nasty U.S. recession will not only penalize world growth but also undermine U.S. prospects by limiting exports.

So far, U.S. data do not point to a broad economic contraction. Yes, the job markets—where the first definitive signs of recession usually show up—are slowing. But the economy is not yet experiencing the sharp payroll drops typical of a recession. Likewise, unemployment has jumped, while new jobless claims have not. That muddied outlook will become clearer on Feb. 1 when the Labor Dept. issues its next employment report. Policymakers and investors around the world will be watching closely.